
Management and Financial Audit of Department of Taxation Contracts

A Report to the
Governor
and the
Legislature of
the State of
Hawai'i

Report No. 10-11
December 2010



THE AUDITOR
STATE OF HAWAI'I

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawai'i State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

1. Financial audits attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.
2. Management audits, which are also referred to as performance audits, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called program audits, when they focus on whether programs are attaining the objectives and results expected of them, and operations audits, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.
3. Sunset evaluations evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.
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5. Health insurance analyses examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.
6. Analyses of proposed special funds and existing trust and revolving funds determine if proposals to establish these funds are existing funds meet legislative criteria.
7. Procurement compliance audits and other procurement-related monitoring assist the Legislature in overseeing government procurement practices.
8. Fiscal accountability reports analyze expenditures by the state Department of Education in various areas.
9. Special studies respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawai'i's laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.



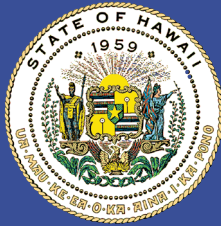
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State of Hawai'i

**“Terrible, terrible,
terrible.”**

— DoTAX deputy director,
when asked to describe
the work environment at
the department in 2009

Recommendations

Responses

Previous Audits

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Report No. 10-11, December 2010

*Lack of planning and fractured management undermine the State's
tax collection efforts*

Unplanned, ill-advised growth

In 1999, the Department of Taxation (DoTAX) began a five-year, \$51 million effort to replace its aging computer systems. By October 2004, the department and its vendor completed six major system implementations. Then, over the next four years, the effort continued with an additional 13 projects and enhancements to the system. This was followed in January 2008 by yet another system enhancement—a \$25 million delinquent tax collections project, which called for an additional 22 new collection initiatives. Long-term planning for these projects was minimal to non-existent, and oversight was left to managers with no formal project management or information technology (IT) background.

Throughout this period, staff were also tasked with developing, testing, and implementing enhancements, fixes, and tax law changes to the growing system. Despite this increased workload, staffing levels have remained relatively constant since 2003. To compensate for this shortfall, DoTAX allowed its vendor to become an essential component in its IT infrastructure. This seeming preference for the vendor over its own internal IT staff led to management conflicts so corrosive the Governor's Office intervened. In 2008, an email from a vendor's manager which used inflammatory language to characterize many DoTAX managers and the work environment, led to further acrimony and a six-month work stoppage that delayed contract deliverables.

A flawed contract, an IT system in trouble

In this environment of discord, the department modified the Delinquent Tax Collections Initiatives contract. We found that this 2009 modification was crafted independently by a former deputy director with no formal IT background or training. It removed the obligation of the vendor to complete the 2008 contract's 22 initiatives as well as a constraint limiting payment to the vendor to \$9.8 million for work on the 2008 contract. Instead, the 2009 modification allowed the vendor to receive the remaining compensation of \$15.2 million from new collections without first completing deliverables from the 2008 contract. In addition, the modification also deleted contract provisions that removed the department's ability to hold the vendor accountable for defects and system integration problems.

We also found that not only is the department unable to sustain the current rate of system enhancements, it will also struggle to maintain current levels of activity without assistance. For instance, the department's funding for the system expansion, a trust account which did not go through the legislative appropriations process, will close on June 30, 2011. With an IT infrastructure in near continuous project development mode for more than a decade, we found an internal staff that is stretched thin and frustrated with spending the majority of their time doing system testing at the expense of other responsibilities. In spite of these problems, the department has not adequately planned for June 30, 2011, when it will lose vendor support and must operate independently.

According to the interim director, the department has initiated corrective actions that will address some of the recommendations noted in our report. The corrective actions include the addition of a position count to the Information Technology System Office to augment short staffing, as well as training an additional ten system administrators to supplement system quality assurance resources. The department is also in the process of identifying project management training opportunities that are available locally. Lastly, the interim director assured us that the department will continue to review our recommendations as it monitors for improvements.

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Submitted by

THE AUDITOR
STATE OF HAWAI'I

Report No. 10-11
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Foreword

This report on our management and financial audit of Department of Taxation contracts was prepared in response to Senate Concurrent Resolution No. 78, Senate Draft 1, of the 2010 legislative session. We conducted the audit pursuant to Section 23-4, Hawai‘i Revised Statutes (HRS), and Article VII, Section 10 of the Hawai‘i State Constitution, which require the Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions. Additionally, Section 103D-107, HRS, *Hawai‘i Public Procurement Code*, establishes a procurement compliance audit unit within the Office of the Auditor to review and assess methods of procurement in use and those proposed to determine whether they promote fairness, efficiency, and accountability within the process.

We wish to express our appreciation for the assistance extended to us by the director and staff of the Department of Taxation and others whom we contacted during the course of our audit.

Marion M. Higa
State Auditor

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Chapter 1

Introduction

This audit of the Department of Taxation was requested by the 2010 Legislature in Senate Concurrent Resolution No. 78, Senate Draft 1 (SCR 78, SD 1). The resolution asks for a management and financial audit of all contracts between the Department of Taxation (DoTAX), CGI Technologies and Solutions, Inc. (CGI), and its predecessor American Management Systems, Inc. (AMS). It also urges the Auditor to use all powers granted by law, including the power to issue subpoenas for witnesses and documents. The resolution also requests the DoTAX to establish and implement a transition plan where DoTAX will assume all functions performed by CGI employees relating to the delinquent tax collection contract. The DoTAX was requested to report to the Legislature on its transition plan no later than August 31, 2010.

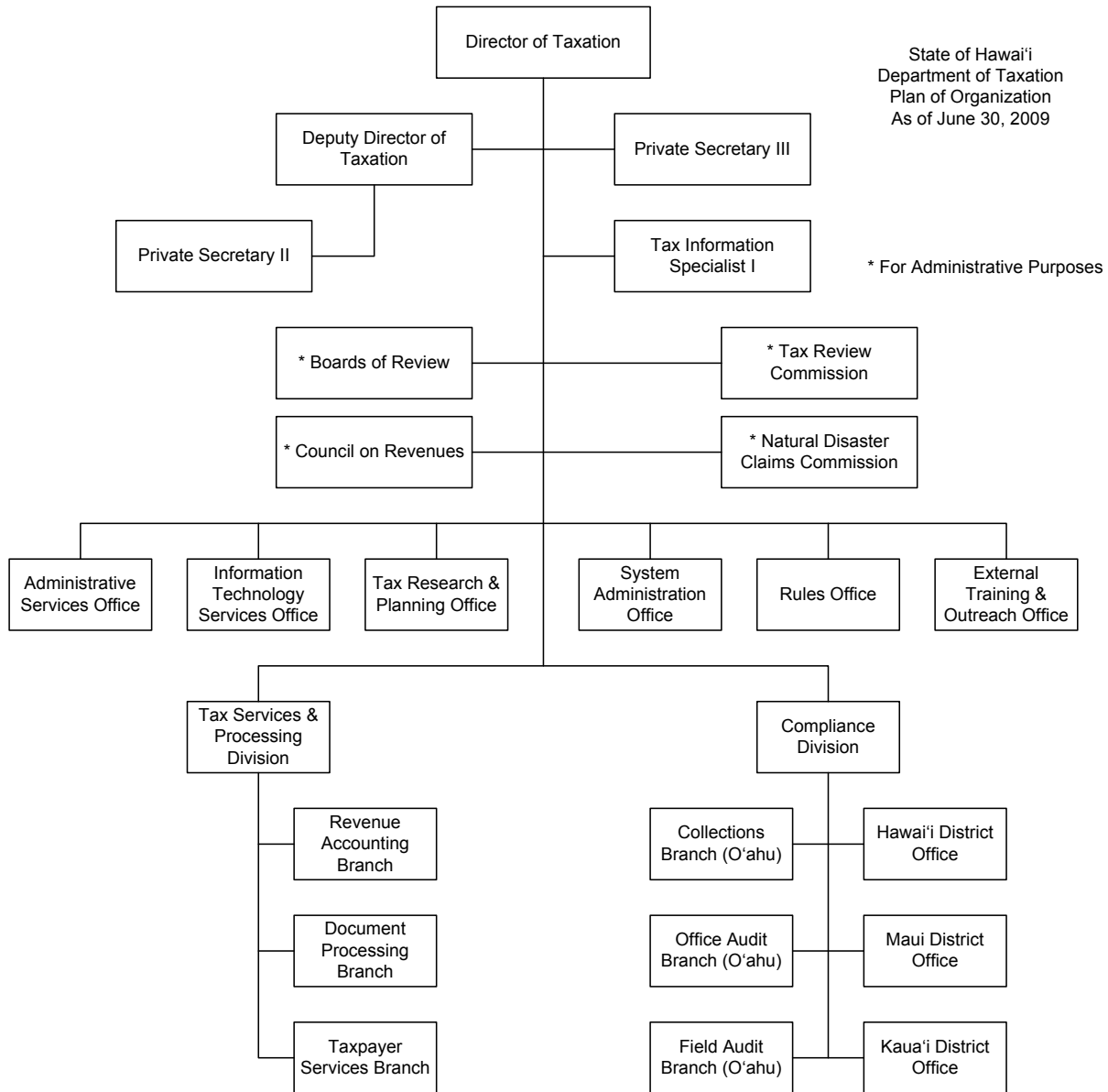
Background

The Department of Taxation's mission statement is "to administer the tax laws of the State of Hawai'i in a consistent, uniform and fair manner by educating taxpayers on tax laws, by developing a professional staff, and by using technology to increase efficiency and effectiveness." The DoTAX focuses on: 1) enhancing and accelerating the revenue stream; 2) providing the best customer care; and 3) facilitating Hawai'i's economic recovery and development. The department is responsible for administering and enforcing tax revenue laws of the State and collecting all taxes and other payments payable thereunder.

Department of Taxation program operational structure

The Department of Taxation is comprised of three key areas: the Director and Staff Offices; the Tax Services and Processing Division; and the Compliance Division. The Council on Revenues, Tax Review Commission, Natural Disaster Claims Commission, and Boards of Review are administratively attached. Exhibit 1.1 displays the Department of Taxation's organizational structure.

Exhibit 1.1 Department of Taxation Organization Chart



Note: As of June 30, 2005, the System Administration Office has been re-assigned to the operating divisions, with half the staff supporting the Tax Services and Processing Division and the other half supporting the Compliance Division. Also, effective July 1, 2009, the External Training and Outreach Office was eliminated.

Source: Department of Taxation

The Director and Staff Offices comprise all offices that report directly to the director of taxation, including: Rules Office, Information Technology Services Office, Tax Research and Planning Office, and Administrative Services Office.

The function of the Rules Office is to serve as the resource for complex policy and recommendations and complex taxpayer support. The Information Technology Services Office (ITS Office) is responsible for the development, modification, and maintenance of the department's computerized tax systems, network, and related components. The Tax Research and Planning (TRP) Office prepares analytical and statistical reports on department activities; forecasts of general fund tax revenues for state budget planning purposes; tax plans; and analytical reports on the revenue effects of proposed tax legislation.

The Tax Services and Processing Division's objective is to perform all functions relating to the centralized processing, editing, and controlling of tax information through paper documents or electronic data; receiving, securing, depositing, and accounting for tax payments; and managing accounts, licensing, and providing taxpayer services to the public. The division consists of three branches: Revenue Accounting, Document Processing, Taxpayer Services.

The objective of the Compliance Division is to maximize taxpayer compliance with Hawai'i's tax laws in a consistent, uniform, and fair manner. The division is composed of the O'ahu Office Audit Branch, O'ahu Field Audit Branch, O'ahu Collections Branch, and the Maui, Hawai'i, and Kaua'i District Tax Offices.

Tax revenue sources

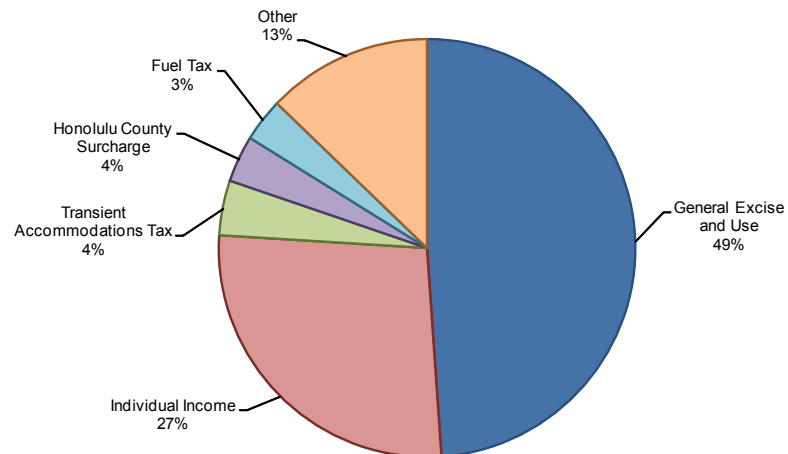
The State's primary source of revenue is the general excise tax, which is levied on the business receiving the income for the privilege of doing business in the state. Gross income from most business activities, including most sales, services, contracting, and rental activities, are subject to the general excise tax of 4 percent, with lower rates or exemptions on certain transactions. The second primary revenue source is the State's income tax, the majority of which is from the tax levied on individual taxpayers.

The DoTAX administers the county surcharge on the State's general excise tax of up to 0.5 percent for the counties. Act 247, Session Laws of Hawai'i (SLH) 2005, authorized the counties to establish this surcharge to fund public transportation systems.

Total tax collection for FY2009 was \$4.944 billion, about 9.8 percent less than FY2008 of \$5.479 billion. For FY2009, the five largest

sources of tax revenue were general excise and use (\$2.418 billion or 48.9 percent), individual income (\$1.339 billion or 27.08 percent), transient accommodations (\$211 million or 4.26 percent), Honolulu county surcharge (\$179 million or 3.61 percent), and fuel (\$166 million or 3.35 percent), totaling \$4.312 billion or about 87.2 percent of total tax collections. The Honolulu county surcharge started in FY2007. Exhibit 1.2 displays the five largest sources of revenue for FY2009.

Exhibit 1.2
Sources of Revenue FY2009



Source: Department of Taxation Annual Report 2008 - 2009

Of the total \$4.944 billion in tax revenues collected for FY2009, 85 percent or \$4.202 billion was deposited into the State's general fund. The remaining tax revenue was distributed among several state special funds, of which the State Highway Fund, the Tourism Special Fund, and the Unemployment Trust Fund were the three largest recipients. These trends are consistent for fiscal years 2006-2008. Portions of the transient accommodations tax went to the Convention Center Fund and the Tourism Special Fund.

The budget process

Hawai'i utilizes a planning, programming, and budgeting system to manage programs and provide for transparency in operation and accountability in execution. Programs are structured to ensure orderly establishment and continuing review and revision to meet objectives and goals. Comparing resources provided to results obtained helps ensure

efficient and effective use of state resources. Departments incorporate their divisions' and attached agencies' individual budget proposals into annual department operating and capital improvement project budgets that are reviewed by the governor, then approved by the Legislature to become law each year.

To support a given request, the department will include budget justification tables. These tables provide line-item detail for personnel, operations, equipment, and capital improvement expenses. Exhibit 1.3 details the Department of Taxation's budget information by program ID for fiscal years 2006 through 2010.

Exhibit 1.3

Department of Taxation Budget Information by Program ID, FY2006-FY2010

		Appropriations				
General Funds		FY2006	FY2007	FY2008	FY2009	FY2010
TAX 102	Income Assessment and Audit	\$4,727,884	\$4,757,096	\$0	\$0	\$0
TAX 103	Tax Collections Enforcement	\$3,440,558	\$3,628,186	\$0	\$0	\$0
TAX 100	Taxation	\$0	\$0	\$9,357,395	\$8,214,860	\$8,870,813
TAX 105	Tax Services and Processing	\$5,655,764	\$6,069,950	\$8,275,362	\$7,449,735	\$6,428,501
TAX 107	Supporting Services – Revenue Collection	\$7,849,807	\$7,380,807	\$7,720,809	\$8,407,448	\$6,876,905
Special Funds		FY2006	FY2007	FY2008	FY2009	FY2010
TAX 107	Supporting Services – Revenue Collection	\$452,000	\$452,000	\$452,000	\$869,000	\$452,000
Total Department Appropriations		\$22,126,013	\$22,288,039	\$25,805,566	\$24,941,043	\$22,628,219

Source: General and Supplemental Appropriations Act. FY2008 - TAX 102 and TAX 103 were consolidated into a new program ID: TAX 100

***Department of Taxation
procurement structure***

The DoTAX follows the State Procurement Office's guidance on the State procurement process.

State procurement process and the Hawai'i Public Procurement Code

Statewide procurement is governed by the Hawai'i Public Procurement Code and the State Procurement Office (SPO). Together they provide a central authority for procurement rules and procedures for all governmental bodies in the State.

The Hawai'i Public Procurement Code, Chapter 103D, Hawai'i Revised Statutes (HRS), was originally enacted in 1993 to promote economy, efficiency, and effectiveness in the procurement of goods, services, and construction of public works for the State and counties. It applies to all procurement contracts made by governmental bodies, unless specifically exempted. The procurement process is meant to foster broad-based competition, providing best value to the State, and also ensure fiscal integrity, responsibility, and efficiency.

Chapter 103D, HRS, establishes the State Procurement Office, which is administratively attached to the Department of Accounting and General Services (DAGS). The SPO advises governmental bodies on the procurement process and serves as the central point for the distribution of procurement circulars, guidance, and directives to all jurisdictions. The administrator of the SPO is the chief procurement officer (CPO) for the executive branch. The CPO is responsible to perform a periodic review of the procurement practices of all governmental bodies; assist, advise, and guide in matters regarding procurement; develop and administer a statewide procurement orientation and training program; and develop, distribute, and maintain a procurement manual for state officials and a guide for vendors.

Chief procurement officers are allowed to delegate any authority conferred by Chapter 103D, HRS, to designees or to any department, agency, or official within their respective jurisdiction. The director of taxation is the designated CPO for the Department of Taxation.

Chief procurement officers' responsibilities for their respective jurisdictions include: procuring or supervising the procurement of goods, services, and construction; exercising general supervision and control over all inventories; and establishing and maintaining programs for the inspection, testing, and acceptance of goods, services, and construction. In addition, the SPO administrator performs periodic reviews of the procurement practices of all governmental bodies; assists, advises, and guides in matters relating to procurement; develops and administers a procurement orientation and training program; and

develops, distributes, and maintains a procurement manual for all state procurement officials. Operational procedures consistent with the statute and Hawai‘i Administrative Rules (HAR) may be adopted within each jurisdiction to assist in the performance of these duties.

Procurement methods

The Hawai‘i Public Procurement Code establishes six procurement methods available for governmental bodies. Two methods are competitive sealed proposals and sole source procurement.

Competitive sealed proposals may be utilized to procure goods, services, or construction when it is not practicable or advantageous to the State to procure by competitive sealed bidding. Prior to the preparation of the request for proposals (RFP), the chief procurement officer will determine whether the officer or an evaluation committee will evaluate the proposals. The evaluation factors set forth in the request for proposals will serve as a basis for the committee to numerically rate the submissions. A request for proposals will be issued with adequate public notice to allow a sufficient number of proposers to participate. Award will be made based on the officer’s or evaluation committee’s recommendation for the proposal that is determined in writing to be the most advantageous, taking into consideration price and the evaluation factors as defined by the request.

Sole source procurement is awarded for goods, services, or construction without competition when the chief procurement officer of a purchasing agency determines in writing that there is only one vendor available. Justification for a sole source must establish that the good, service, or construction has a unique feature, characteristic, or capability essential to the agency to accomplish its work and can be satisfied by only one vendor.

Exemptions

Besides statutory exemptions that exclude applicability of the procurement code, the code itself allows exemptions from certain aspects of the above procurement methods. In some instances, while the procurement for some goods and services are available from multiple sources, it may not be practicable or advantageous to the State to procure competitively. Either the procurement policy board determines by rules or the SPO administrator determines in writing that a prior situation exists to justify an exemption from the procurement code. While an exemption may exist, governmental bodies are always encouraged to adopt the spirit of the procurement code and use provisions of the code and its own rules when procuring goods, services, or construction.

CGI Technologies and Solutions, Inc.

CGI Technologies and Solutions, Inc. (CGI) is an information technology (IT) and business process services provider founded in 1976 in Quebec City, Canada. Since that time the company has grown to include 26,000 employees operating in 107 offices worldwide with 2009 revenues of \$3.8 billion. The company's portfolio of services includes systems integration and consulting, application management, technology management, and business process services. In May 2004, CGI acquired American Management Systems, Inc. (AMS), which doubled the size of CGI in the United States. CGI and its predecessor AMS have been the department's IT vendor since 1999.

Department of Taxation performance-based contracts

In Act 218, SLH 1995, the Legislature appropriated \$2,540,046 in general funds for the design of a new Integrated Tax Information Management (ITIM) system. The DoTAX's old Comprehensive Net Income Tax system, which was prone to failure, would have been unable to process income tax returns at the turn of the century and keep pace with changing requirements.

The Legislature also became aware that the DoTAX would have been unable to implement tax law changes rapidly without adversely affecting its processing of tax returns. In addition, the fiscal crisis during the mid-1990s focused attention on raising revenue more efficiently, including the use of automated systems.

In 1996, through Act 273 the Legislature authorized DoTAX to enter into performance-based contracts with a private vendor for its System Replacement Project. Act 273 defines a *performance-based contract* as:

A contract under which compensation to the vendor shall be computed according to performance standards established by the department. Any performance-based contract entered into by the department for such purpose shall provide:

1. For the payment of fees based on a contractually specified amount of the increase in the amount of taxes, interests, and penalties collected and attributable to the implementation of automated tax systems; or
2. For the payment of fees on a fixed-fee contract basis to be paid from the increase in the amount of taxes, interest, and penalties collected and attributable to the implementation of automated tax systems.

Integrated Tax Information Management system

In 1999, DoTAX commenced the five-year ITIM system project to replace its aging computer systems for income and business taxes and to “re-engineer” the organization to become more efficient and effective in accomplishing its mission. Using the competitive sealed proposal procurement method, the department entered into a performance-based contract in August 1999 for the ITIM system with CGI (formerly AMS). The total contract price was about \$51 million. To pay for the system, the 1999 Legislature established the Integrated Tax Information Management Systems Special Fund, which consisted of general excise tax revenues. The fund had a July 1, 2005 sunset date.

Since then, there have been numerous supplemental agreements, contracts, and memorandums of understanding for enhancements, modifications, and product support through 2007. The total contracted price to CGI for these supplements and modifications was approximately \$10.8 million, bringing CGI’s total compensation for ITIM system from inception to 2007 to about \$62 million.

Delinquent Tax Collection project

In 2008, the DoTAX entered into a benefits-based (contingency fee) contract with CGI for the Delinquent Tax Collection project. This sole source award was executed in January 2008 with a contract price of \$25 million and subsequently amended in June 2009. The contract provides for payment to CGI at a compensation rate of 33.3 percent of all new collections realized until the maximum amount of \$25 million has been paid.

The Delinquent Tax Collection project’s three main objectives are to: 1) encourage taxpayers to timely file their tax returns and pay the tax owed; 2) enhance the department’s ability to collect taxes legally owed to the State; and 3) clear the business account registration rolls of accounts that are no longer active by encouraging taxpayers to cancel unneeded accounts.

The first phase of the project involved the Registered Business Non-filer project, beginning with the General Excise Tax Non-Filer project component in June 2008. This component focused on general excise tax licensees who had not filed general excise tax returns for tax years 2001 through 2007. The initial phase of the Withholding Tax Non-Filer Initiative commenced in November 2009 for withholding tax returns for tax years 2001 through 2008. As of June 2010, gross collections for the non-filer project exceeded \$75 million—less than 1 percent of the total state tax collections of \$10.5 billion for the same period—allowing CGI to be paid the maximum contract amount of \$25 million.

Hawaii Government Employees Association prohibited practice complaint

In June 2009, the Hawaii Government Employees Association (HGEA) filed a prohibited practice complaint against the department, alleging the department had privatized computer and computerized tax services to an outside vendor, CGI, in violation of Sections 89-13(a)(5) and 89-9, HRS. This provision prohibits a public employer from entering into private contracts for jobs customarily and traditionally performed by civil service employees without first bargaining with the employees' representative. The association represents certain DoTAX employees. The allegations include CGI's employment of "dozens of analysts, programmers, and testers, who are paid \$200/hour, while state employees continue to conduct work for which CGI continues to be paid."

Prior audits

Our office, in conjunction with CPA firms that we contracted with, has conducted four financial audits of the Department of Taxation to examine the department's financial records and its systems of accounting and internal controls and tested these for compliance with applicable laws and regulations. These are Report Nos. 75-5, 85-3, 94-20, and 96-9. Examination of the financial statements was performed by the CPA firms. In general, the CPA firms found that the statements, except for the general fixed assets account group (which was not included in the terms of their engagement) presented fairly in all material respects the financial position of the department for the years audited.

In Report No. 75-5, *Financial Audit of the Department of Taxation*, we found a lack of sufficient controls over tax payments made in several areas, inequities in the real property tax assessment, and inefficiencies in refunding overpayments of income tax to taxpayers as well as in the examination of income tax returns. We recommended the establishment of accounting controls in certain areas, taking steps to review, adjust, and establish definitive policies and guidelines for real property tax assessments, and discontinuing the department's practice of examining every tax return that shows an overpayment of taxes before refunding the overpayment to the taxpayer.

In Report No. 85-3, *Financial Audit of the Department of Taxation*, we found that the department's staff was relying on incomplete records of authoritative information in the administration of the general excise tax law. Also, the department was not providing sufficient public information to assist the taxpayer in complying with the tax law or to ensure the uniform application of the tax among taxpayers. Our audit found that the department had failed to correct several of the conditions noted in our 1975 audit. We recommended that the department centralize the compilation and maintenance of all authoritative information, classify

its official position with respect to various statements and releases, and reissue past publications of General Excise Tax Memorandums and information bulletins to eliminate any confusion regarding authoritative source. We also recommended that the department establish accounting controls over all mailed-in tax payments, review its security measures to protect valuable records, documents, and files from destruction by fire, and establish a random audit selection process and maintain statistics on the outcomes and characteristics of the taxpayer.

In Report No. 94-20, *Financial Audit of the Department of Taxation*, we found that although the department had implemented most of the recommendations made in our 1985 report, it did not consider the use of a depository system to reduce delays in depositing receipts. In addition, we found that the department could improve its ability to collect taxes by strengthening its internal control and administrative practices and resources. Specific to the department's Comprehensive Net Income Tax (CNIT) system, which processes and accumulates income tax return information, our audit found inefficiencies that prevent the department from efficiently comparing data among the different computerized tax systems or compiling data from the CNIT system based on key attributes. We recommended that the department re-program its computer system to identify taxpayers who have not filed the required tax returns, document the approvals obtained for the payment plans of delinquent taxpayers, and re-examine its practices of not initiating foreclosure proceedings on delinquent taxpayers.

Finally, Report No. 96-9, *Follow-Up Audit of the Department of Taxation*, was conducted by our office as a follow up to the 1994 audit. We found that the department had taken positive steps to implement the recommendations of the 1994 report and also initiated additional actions to improve tax collections and enforce compliance. The department, however, was not able to fill vacant positions in its audit and collection divisions due to budget restrictions. We recommended that the department continue to follow its new collection procedures and to implement its new computer system.

Objectives of the Audit

1. Assess the adequacy of the Department of Taxation's strategic planning for and procurement of its IT systems/projects.
2. Assess the adequacy of the department's management of its CGI contracts.
3. Make recommendations as appropriate.

Scope and Methodology

As requested by the 2010 Legislature in SCR 78, SD 1, our management and financial audit focused on the contracts between the DoTAX, CGI, and CGI's predecessor AMS, for the period ending June 2010. We included prior years from 1999, the inception of the first contract with AMS, as deemed necessary. We conducted interviews with selected administrators, managers, and staff in the DoTAX, CGI, as well as the Office of the Governor, and other agencies, organizations, community groups, and individuals as required. Our audit included a review of policies and procedures, letters, emails, reports, and other relevant documents and records to assess and evaluate management's compliance with statewide procurement policies and procedures and other pertinent laws, rules and regulations, and policies and procedures.

We tested a sample of relevant documents and reports, reviewing specifically for compliance with applicable provisions of contractual obligations, state procurement laws, rules, policies and procedures, as well as with the DoTAX's own internally prepared policies and procedures. We altered our testing procedures, however, because of constraints placed on our access to both department documents and staff by the director of taxation.

Auditor's authority to access information

The Office of the Auditor has broad authority to access information. Section 23-5, HRS, gives the Auditor authority to examine and inspect all accounts, books, records, files, papers, and documents and all financial affairs of every department, office, agency, and political subdivision. Further, Section 92F-19, HRS, of the *Uniform Information Practices Act*, requires agencies to share records with the Office of the Auditor. The administration's withholding of records from our office during this audit is in contravention to the law and prevents the Auditor from carrying out her constitutional and statutory audit authority. We find the administration's efforts to stymie our audit contrary to the Legislature's directive in provision SCR 78, SD 1, to cooperate with the audit to the fullest extent possible.

Auditor's access to information

At the onset of our audit we requested department information, documents, and electronic mail. A request for documents is standard procedure during the preliminary planning phase and fieldwork of an audit. Our first request for documents to the department was on June 1, 2010, with the final delivery of documents and information from this first request received four months later on October 18, 2010.

Our first request for department electronic mail to the Department of Accounting and General Services was made on June 29, 2010. The comptroller replied on July 8, 2010 that he was conferring with the affected parties and would provide a more complete response thereafter. On July 21, 2010, at the request of the comptroller, we rescoped our request to key words and individuals due to the volume of email accounts from our original request. On July 27, 2010, the comptroller responded that his office was beginning a search of all affected email accounts and would make every effort to produce the requested documents given personnel reductions, limited resources, and the need to coordinate with other affected agencies and the Department of the Attorney General. On September 10, 2010, we received the first production of emails requested from the Department of the Attorney General, which consisted of a single, two-page email. On November 10, 2010, four months after our initial request, we received the final email production.

Further, the current DoTAX director has taken an active role in our audit, which is unique and unprecedented and has hindered our audit work. We were told that due to confidentiality privileges relating to taxpayer communications, all requested documents must first be collected, screened, and culled by the department, with a final review by the director. According to the director, the review was intended to remove any confidential taxpayer information. We find this unnecessary given that the Internal Revenue Service allows inspection of returns and return information by state audit agencies charged under the laws of the State to audit state revenues and programs.

We were also restricted access to various DoTAX work areas that could have put us in contact with taxpayer information. As a result, we were required to request department documents rather than pull the information ourselves and interact with staff directly. According to the director, our request for documents resulted in more work for the department staff. We reiterate that there would have been no impact to the department's workload had we been allowed to conduct our audit according to our routine procedures and protocols.

Records disclosure

Requested documents and emails have been screened and released piecemeal to us over an extended period of time, from June 2010 through November 2010. We were also told by a deputy attorney general that several tax division attorneys had been screening the documents twice for subject matter relevance and attorney-client and executive privileged information, a unique and time-consuming process.

Audit interviews

The department also interceded in our audit interviews of current DoTAX employees. We were told that the director required employees whom we interview to notify their division administrators and office chiefs. Employees and division and office chiefs who did not comply were routinely reprimanded by the director. In addition, any documents discussed in the interview and requested by us were collected, screened, and culled by the department, with a final review by the director prior to release to our office. Overall, the overt efforts by the department to control and stall our audit were unprecedented, delayed our work, and compromised our audit process.

Audit standards

Our audit was conducted from June 2010 through November 2010 pursuant to Section 23-4, Hawai‘i Revised Statutes, which requires the Auditor to conduct post audits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions; and according to generally accepted government auditing standards and the Office of the Auditor’s *Manual of Guides*. These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Chapter 2

Lack of Planning and Fractured Management Undermine the State's Tax Collection Efforts

In 1999, the Department of Taxation (DoTAX) began an effort to replace its aging computer system, which had become increasingly unable to process income tax returns and fulfill the growing needs of Hawai'i's tax system. The department contracted with an IT vendor to develop and install a new, integrated tax information management system; however, ten years and \$87 million later, with IT contracts still on-going, the system has yet to be finalized. A lack of planning by department leaders has allowed the vendor to become an essential and entrenched component in the department's IT infrastructure. In addition, ill-equipped project managers contributed to poor contract oversight and weak vendor accountability.

Focused mainly on revenue collection, the department took on too many projects with insufficient staffing and budget resources. As a result, the department's IT systems may not be sustainable without continued support from the vendor, which is scheduled to terminate services in June 2011. Also, when its director leaves in December 2010, the department will be anchored by a management team rife with internal conflict. Without a transition plan in place, DoTAX and its IT infrastructure face a precarious future.

Summary of Findings

1. The Department of Taxation's poor IT project management led to a contract that is not in the best interest of the State.
2. The department's failure to develop and implement an effective strategic plan threatens the sustainability of its IT infrastructure.

The Department's Poor IT Project Management Led to a Contract That Is Not in the Best Interest of the State

The department's performance as the tax collection arm of the State has been hampered by its inability to effectively manage its IT systems contracts. Poor leadership and internal management strife along with minimal project management and training has resulted in weak IT contract accountability. In addition, oversight of key IT contracts was left to managers with no formal project management or IT background. The department subsequently failed to follow through on contract project management provisions. As a result, the department cannot accurately

account for its IT vendor's hours, which raises questions about whether taxpayers have received full value for the millions that have been spent on these contracts.

The tax department also suffered from management conflicts and a dysfunctional work environment that was exacerbated by a derogatory email from its IT vendor. Those factors led to a six-month delay in the adoption of potential revenue-generating initiatives and helped spur a 2009 contract modification that was developed in secret, eliminated previously required deliverables, and reduced vendor accountability.

We reviewed the department's IT contracts and found that the procurement and payment methods of the 1999 ITIM system contract were transparent. In contrast, the 2008 contract was less transparent in both its procurement and payment methods. In fact, the contract's payment mechanism is questionable.

DoTAX's poor IT project management enabled weak vendor accountability

We found that within the executive branch there is very little guidance provided to staff to oversee and manage the tax department's multi-million dollar IT contracts. Instead, the department relies upon its in-house expertise, which we found to be lacking. Although DoTAX management could have relied upon project management provisions in its various IT contracts, we found that follow-through on these provisions has been inadequate. In addition, the department has failed to maintain an accurate accounting of the vendor's work hours, resulting in weak vendor accountability.

Lacking statewide and departmental IT project management guidance, DoTAX leaders relied on inadequate in-house expertise

The State does not provide project management guidance or oversight over IT contracts and provides only minimal contract management training to the executive branch departments. The Information and Communication Services Division (ICSD) is the lead agency for information technology in the executive branch. The branch chief of the ICSD's Planning and Project Management Office stated that her office does not provide IT project management guidance to the executive departments.

In addition, the State Procurement Office (SPO), which provides authority for procurement rules and procedures for all governmental bodies in the State, conducts only one workshop on contract administration and makes available on its website a handout called

Contract Administration. The governor's chief of staff stated that, as a general rule, the State does not provide guidance and oversight to large IT projects undertaken by the various executive departments.

Moreover, the DoTAX does not have documented policies, procedures, guidelines, tools, or methodologies for project management. Key managers referred to "on-the-job-training" and pointed out that much of their guidance came from a multitude of department sources, something they referred to as "fractured documents."

According to Control Objectives for Information and Related Technology (CobiT), a generally accepted internal control framework for IT, a project management framework ensures the correct prioritization and coordination of all projects, reduces the risk of unexpected costs and project cancellations and helps ensure the value and quality of project deliverables. In addition, the Institute of Internal Auditors' (IIA) Global Technology Audit Guide 12: Auditing IT Projects (GTAG® 12) lists several rules for success, including having a formal methodology with a predefined set of process-based techniques that provide a road map on when, how, and what events should occur in what order; as well as building and managing the project infrastructure with tools that enable management of tasks, resources, requirements, change, risks, vendors, user acceptance, and quality management. Although CobiT and GTAG® 12 do not guarantee a problem-free project, they emphasize the importance of having a formal methodology as well as tools and infrastructure to support project management. We found that the DoTAX lacks both.

Since 2006, the DoTAX IT project managers have had no project management or IT background and training. The project manager responsible for a \$2.44 million IT project in 2006 and a \$25 million IT project in 2008 had no prior project management or IT background or training. The department director, who is the current project manager for the department's IT projects, also has neither a project management nor IT background.

The GTAG® 12's list of rules for project success encourages organizations to use project managers who understand the basic skills and practices, such as certified Project Management Professional from the Project Management Institute or the like. Similarly, the National State Auditors Association's Best Practices Document, *Contracting for Services*, states that contract monitoring is essential, one element of which is to ensure that the contract manager possesses adequate skills and has the necessary training to properly manage the contract.

Thus, lacking both project management guidance and project managers with project management experience and IT background, the department

relied upon project management provisions written into its IT contracts for guidance. However, even though the contracts contained such provisions, DoTAX project managers did not follow through with them.

DoTAX's failure to follow contract provisions led to weak vendor accountability

We found that project management provisions were included in the various IT contracts dating back to the original 1999 ITIM system contract. In fact, the 2008 Delinquent Tax Collection contract and the subsequent 2009 modification also contained project management provisions. Although both contracts included such provisions, the department's follow through on several of them was inadequate. For example, a project plan for the 2008 contract was not developed, an executive steering committee did not provide on-going oversight for both projects, and monitoring of vendor work hours for the 2009 modification was inadequate. Exhibit 2.1 summarizes the department's follow through with 2008 contract and 2009 modification requirements.

Exhibit 2.1

Summary of Department Follow Through With Contractual Requirements

2008 Contract Requirement	As Defined by Contract	Adequately Implemented?
Project Notebook	Sets standards by which the project will be managed and conducted.	No
Project Plan	Governs the parties' responsibilities under the contract and project schedule.	No
Executive Committee	Comprised of senior management from DoTAX and CGI. Meets semi-monthly or as mutually agreed upon.	No
2009 Modification Requirement	As Defined by Modification	Adequately Implemented?
Project Plan	Created within 60 days of contract execution. Addresses the process for approvals, issue resolution, and project reporting.	Yes
Executive Committee	Comprised of DoTAX and CGI members including the department director. Supports delivery of the project.	No
Staff Utilization Plan	Created within 60 days of the contract execution. Sets the revenue generating activities, the general tasks that each CGI consultant will perform, and the terms concerning leave time.	No

Source: Data compiled by Office of the Auditor

According to the 2008 contract, project management would be a partnership between the DoTAX and the vendor. A *project notebook* was specified to establish standards to manage the project. The project notebook would, at a minimum, address procedures and requirements for the following: deliverable review and approval; change control; project plan updates and maintenance; issue tracking and management; document numbering and storage; meeting minutes; status reporting; and incident tracking and management. The department did not establish a project notebook.

The 2008 contract also specified that a *project plan* would govern the respective responsibilities under the contract as well as the project schedule. The vendor's project manager was responsible for providing updated versions of the project plan as part of the regular project status report. The department did not have a project plan; instead, it had several charts and timelines. The department pointed out that the project plan is defined in the contract as "the mutually agreed schedule to implement project activities." We note, however, that the department's charts and timelines do not govern the parties' respective responsibilities as required by the contract.

Likewise, the 2009 modification also required a project plan. When we requested a copy of the plan for the 2009 modification, the department initially responded that the "Project Plan is defined in Statement of Work No. 1 as 'the mutually agreed schedule to implement project activities'" and provided the schedules. Seven weeks later, the department sent us its *project management plan* and explained that the plan details the project management process that governs the 2009 modification. We question why the project management plan was not sent to us in our initial request for a project plan and more importantly, why such a plan was not created for the 2008 contract.

The 2008 contract also stated that the department and the vendor would hold executive steering committee meetings semi-monthly or as mutually agreed upon. The executive steering committee would be comprised of senior management from both the department and the vendor. Although the department established such a committee, known as the Oversight Committee, the committee was discontinued within a year of the signing of the 2008 contract. The committee maintained an open and closed log to record its discussions—the last entry was on October 8, 2008.

The 2009 modification also called for an executive committee that would meet as needed. In addition, the contract stipulates that the committee would include the department director, its project manager, and a person of comparable standing from a department outside DoTAX. The vendor's members would include its project manager, area account manager, and one other individual of its choice. According to the

department, an executive committee was never formed. By disbanding its Oversight Committee in 2008 and failing to re-establish one after the 2009 modification was signed, the department ignored a clear contractual requirement, effectively removed a layer of oversight and accountability, and weakened its project management structure.

According to the National State Auditors Association's (NSAA) Best Practices Document, *Contracting for Services*, once a decision to contract has been made, the agency should develop performance requirements that will hold vendors accountable for the delivery of quality services. The NSAA also warns that without a sound monitoring process, the contracting agency does not have adequate assurance that it receives what it contracted for. In the case of DoTAX's \$25 million contracts in 2008 and 2009, and contrary to the NSAA's best practice guidelines, the department inadequately monitored the vendor's work hours.

The 2009 modification specified that within 60 days of the execution of the modification, the vendor and DoTAX would mutually agree on a staff utilization plan that would identify DoTAX's revenue-generating selections as well as the vendor's other services. The plan would be updated at least monthly and would contain, at a minimum, the general tasks that each vendor consultant would be performing monthly for the ensuing six-month period, as well as reasonable sick and vacation time allowances. The department developed a staff utilization plan in June 2010 in response to our request, a year after the modification's effective date. When asked how the department had accounted for the vendor's time prior to June 2010, the department responded that it had not done so.

We reviewed the staff utilization plan and found that it identified the individual vendor consultants and listed the percentage of time that each consultant worked on various initiatives. However, contrary to contract requirements, the plan did not include the general tasks that each vendor consultant would be performing monthly for each ensuing six-month period, nor did it mention leave allowances. The department did not require the vendor to make up or substitute those hours. In fact, the department confirmed that these were "lost hours." Without a more precise accounting of the vendor's work, vacation, and sick leave hours, the department cannot ensure it is receiving maximum value from its \$25 million contract.

Management conflicts contributed to a 2009 contract modification that was hastily conceived and vague and lacked vendor accountability

Conflicts over how IT work was apportioned to departmental employees and CGI resulted in a dysfunctional work environment at the department. These differences grew as the department increasingly relied on CGI for IT work. Eventually, a derogatory email from a CGI manager to the former state tax director exacerbated existing rifts within the department and with CGI. The ensuing halt in services and a disagreement over contract terms resulted in a 2009 modification that was developed in secret. That modification departed from the department's procurement practice, eliminated previously required deliverables, and reduced vendor accountability.

Management conflicts resulted in a dysfunctional workplace environment

Many conflicts existed among taxation managers resulting from contrasting personalities, parochial interests, and perceptions that some tax department managers favored CGI at the expense of department IT staff. The department's reliance on CGI for ongoing information technology support has been a source of internal strife because of department management's inability to deal with dissent among its employees as it became increasingly dependent on CGI to manage and upgrade the ITIM system.

The governor's chief of staff stated there was a lot of antagonism between certain members of the department management team and CGI, which should have been addressed by leadership. One former tax department manager described department managers as having strong personalities and opinions, which resulted in conflict in meetings. Another tax department employee stated, "The divisions and staff offices were against each other. The department wasn't whole."

Department leaders' inability to deal with ongoing internal conflicts and properly manage the department's relationship with CGI resulted in intervention by the Governor's Office. On two occasions the office removed responsibility for managing the CGI contracts from the former department director. In both cases that responsibility was shifted to a deputy director who had no prior project management or IT background apart from what was acquired while on the job. Following one intervention by the administration, the deputy director was instructed to report on project progress to the governor's chief of staff. These interventions subverted the department's management structure and weakened the relationship between the director and a deputy director within the department.

In addition, a former tax department manager said there was competition between the internal IT office and CGI for work and that the manner in

which IT initiatives were directed to CGI resulted in perceptions that "...how [tax department managers] were using and approving the hours was troubling...it was an [internal IT office] versus CGI to fix it...there were multiple instances where the administration would decide to give work to CGI rather than [the internal IT office]."

Under general terms outlining the department's relationship with CGI, tax department practice provided the department's ITS Office with a so-called "first right of refusal" in which internal IT staff would be given the opportunity to decide whether to perform work on new IT projects. In reality, CGI was given more ITIM system-related business, while tax department IT staff expressed concern that upgrades that could be done more cheaply internally were being outsourced. The manner in which the tax department apportioned work between its staff and vendor contributed to the growing discord. Some department managers said the internal IT office struggled to deal with new and existing projects. This drove work to CGI and fueled a perception that some managers favored CGI. Eventually, strong supporters of CGI and those who were anti-CGI formed separate factions within the agency.

Disagreements over how work was apportioned between CGI and state employees also resulted in a complaint filed against the department by the Hawaii Government Employees Association (HGEA), the union representing many of the department staff. The complaint was lodged on behalf of department workers who believe civil service jobs were being wrongly taken by CGI employees.

To resolve these conflicts, the tax department needs to attend to practices and problems that eroded working relationships among employees and CGI. According to *Resolving Conflicts at Work*, a book by Kenneth Cloke and Joan Goldsmith, workplace conflicts that seem unique or personal can become widespread as a byproduct of a dysfunctional environment. This book posits that it costs more money and time to leave workplace conflicts unresolved than to solve them, stating that:

The opportunity costs of leaving these conflicts unresolved can be measured indirectly in the failure of the organization to adapt, evolve and change. Yet most of these chronic conflicts are missed because the organization sees them as purely personal or a result of "personality clashes."

As a result of this dysfunction, the tax department may not meet the June 30, 2011, deadline to transition away from the IT contractor. "There is still a trust issue across the board" within the agency, according to one tax department administrator. The agency's director stated that some hurt feelings remain within the department. "Most people have moved on, but some have not," he said.

Derogatory email from IT vendor fueled dissension among DoTAX managers

Tensions between department officials reached a boiling point when a CGI manager sent a defamatory email on October 8, 2008 to the then-tax department director. The email described the agency as “operating in a dysfunctional management environment” and blamed the then-director for being unable to manage the situation. The email said the then-tax director “had no management or leadership skills” and recommended that he be “taken out of the picture” as a manager of the CGI contract. The email recommended that the then-deputy director be put in charge of the contract—a move the administration would later implement. The email, which was derogatory to some but not all managers, was credited by one deputy director with creating a “terrible, terrible, terrible” work environment that fostered division.

The former tax director said the email characterized people in a mean-spirited way, labeling some tax department managers in a derogatory fashion using inappropriate nicknames. Certain tax department employees who were deemed “dissidents” were characterized in disparaging ways, including:

- “Clinically psychotic”;
- “Smart yet can be very air headed”;
- “Weak leader and easily manipulated”;
- “EXTREMELY ODD [PERSON]”; and
- “Not respected by his peers within the state.”

One tax department manager who was not criticized felt isolated and deemed guilty of cooperating with CGI, while another manager said statements in the email strained and altered working relationships.

Following the email, some department managers wanted to terminate the CGI contract; however, it was unclear whether the department could sever the deal without spurring a lawsuit. The Governor’s Office told the department it could cancel the contract, if it could still bring in the projected \$50 million net revenue within an acceptable amount of time. CGI also requested a meeting with the Governor’s Office to disengage from the contract.

From October 2008 to March 2009, tax department management essentially stopped working with CGI. During this period managers stopped having ITIM system project-related committee meetings and CGI expressed concerns on the effect this was having on the project.

A CGI executive notified the department that CGI terminated the project manager responsible for sending the email. The then-deputy director

managing the project felt that the department would be unable to generate an added \$50 million in net delinquent tax collections without CGI.

However, even if the department wished to cancel its contract with CGI, it may not have been able to do so. Prior to the email, there was a disagreement between CGI and the tax department regarding the scheduling of payments for Phases 1 and 2 of the contract. Under the contract, CGI was to receive one-third of delinquent taxes the company helped generate. However, a separate contract provision limited payments to the company at \$9.8 million until other system upgrades were complete. The issue was at a standstill with attorneys. The tax department was advised that litigating the issue “would be expensive.” This contract dispute and the email drove the decision to modify the CGI contract in mid-2009. “There were personality disputes, resource disputes and legal disputes between the department and the contractor. The amendment helped to resolve these,” said a deputy attorney general who advised the tax department during the contract modification.

2009 modification was developed in isolation and secrecy

The defamatory email and the resulting ill feelings of management led to the development of the 2009 modification by a single department employee—the former deputy director—without the involvement of the then-director and key managers. According to the former deputy director, after the email, the majority of the managers and the then-director wanted to terminate the contract. Instead of seeking their input, the former deputy director sought assistance from the Department of the Attorney General and the governor’s chief of staff.

Although the key managers were aware that the contract modification was being drafted, they did not see the modification until after it was executed. CGI signed the modification on Tuesday, June 23, 2009. On Wednesday, June 24, 2009, the former deputy director held a meeting with the department’s managers. At this meeting, the managers were provided a summary of the contract modification prepared by the deputy attorney general. The former deputy director told the managers that the modification was withheld from them because of the HGEA prohibited practice complaint.

On Friday, June 26, 2009, the former deputy director asked the internal IT staff which projects it could perform from the modification summary and requested their response by the following Monday, June 29, 2009. The ITS Office chief responded on Monday morning via email that “due to the absence of any input by business units, [the ITS Office] would not be acting responsibly by selecting projects in isolation of needed input by others. Also, there appears to be no overall business priorities

established by the department.” Undeterred, the former deputy director signed the modification that same day—Monday, June 29, 2009.

The chief of staff did not know who was involved in developing the modification but assumed that the “core team” was working on it. The deputy attorney general stated that it would surprise him if the contract modification was drafted by a single person within the department. He claimed to know first-hand that there were a number of managers involved in the negotiation process, but cited attorney-client privilege when declining to reveal who those managers were or what was discussed. Moreover, the deputy attorney general stated that whoever claimed that the modification was drafted by only one person was misinformed. However, contrary to what she told the department staff at the time, the former deputy director stated that her decision to not involve the then-director and managers was influenced by the email controversy. She believed that the derogatory nature of the email made it unlikely that she would receive dispassionate input from the department officials. Thus, developed in isolation and without the assistance of the director and key managers, the 2009 modification not only failed to follow the department’s procurement practice, but more significantly was ill-planned, hastily conceived, and vague.

2009 modification departed from department’s procurement practices

We reviewed the 1999 Integrated Tax Information Management (ITIM) system and the 2008 Delinquent Tax Collection Initiative contracts and found that both were procured according to the department’s procurement practices. However, we found that the 2009 modification did not follow department practices. Contrary to those practices, the 2009 modification did not involve the department administrative services officer (ASO), and management reviews were not documented.

The 1999 ITIM system contract was procured through the request for proposal (RFP) method. In our review of the contract file, we noted that the ASO was involved and proper management reviews and approvals were evidenced throughout the process. As required by Section 103D-303, HRS, which governs the competitive sealed proposal method of procurement, public notice was given, three proposals were received, and the award was made appropriately. The contract also clearly defined the services to be provided in the Statement of Work 1-12 and contained standard contract language.

The 2008 Delinquent Tax Collection Initiative contract was procured utilizing the sole source method. Section 103D-306, HRS, which governs the sole source method of procurement, requires the SPO chief

procurement officer's approval. We found that the SPO approved the department's sole source request based on the information provided by the department that the contractor developed the software and retains ownership of the software codes. Similar to the 1999 ITIM system contract, we found that the ASO was involved, proper management reviews and approvals were evidenced throughout the process, and the contract contained clearly defined services.

However, we found that the 2009 contract modification departed from the department's procurement practices. In contrast to the 1999 and 2008 contracts, the 2009 modification did not involve the ASO, and management reviews and approvals were not evidenced throughout the process. According to the department's expenditure cycle flowchart on source selection, the ASO is responsible to assist in identifying the appropriate procurement method. We found that the ASO did not assist with identifying the procurement method and in fact only became aware of the type of procurement after the modification was executed and SPO posted on its website. The former deputy director said that she was aware that it is part of the ASO's duties, but she chose not to involve the ASO.

According to U.S. Government Accountability Office (GAO) *Standards for Internal Control in the Federal Government*, November 1999, internal control activities help to ensure that management's directives are carried out and are effective and efficient in accomplishing the department's control objectives. Control activities are the policies and procedures, techniques, and mechanisms that enforce management's directives. They help ensure that actions are taken to address risks.

The negative environment brought about from the email does not release the department from following its procurement processes and procedures. By not including the ASO and the managers in its process, the department compromised its control activities and failed to comply with its procurement practices.

2009 modification abandoned 2008 contract deliverables and vendor accountability

We found that the 2009 modification was driven by the administration's need to bring in revenue and did not protect the State's interest. The 2009 modification released the vendor from 2008 contract deliverables, removed payment constraints, deleted acceptance testing and warranties thereby releasing CGI from accountability, and relieved CGI of any obligation to complete on-going initiatives.

First, the 2008 contract identified 22 initiatives and their deliverables. The contract defines *deliverables* as tangible materials that are prepared

by CGI and delivered to DoTAX in the form of (1) written documents, including reports, system documentation, system design, and blue prints; (2) software, including developed software and third-party software; and (3) hardware, including personal computers, routers, and mini processors. The 22 initiatives were divided into two phases. Phase 1 initiatives were to be implemented within the first 24 months after the effective date of the contract. Phase 2 initiatives were to commence if the collections from Phase 1 initiatives were sufficient to compensate CGI with \$9.8 million.

The 2009 contract modification removed the obligation of the vendor to complete the 2008 contract's 22 initiatives. Instead, the modification included a list of 21 revenue generating initiatives from which DoTAX could choose, but did not define deliverables or include a time table for delivery. The 2009 modification provided for ten CGI consultants to perform services "as directed by DoTAX." Of the 21 initiatives, DoTAX chose five for CGI to complete. Appendix A compares what was originally contracted for in the 2008 contract with what will actually be delivered by the 2009 modification.

According to best practices, National State Auditors Association, *Contracting for Services*, contract provisions should include tying payments to the acceptance of deliverables or the final product. Because the 2009 modification does not tie payments to deliverables and, in fact, does not define deliverables, the department received less value and accountability than in the 2008 contract.

The modification offered a "buffet list" of initiatives from which the department could choose. The former deputy director picked the list herself without consulting department managers, the Department of the Attorney General, or the Governor's Office. The governor's chief of staff, however, was aware that the department intended to modify the contract to offer a cafeteria-style buffet list of options. The vendor's project manager commented that the 2009 modification terms are unusual in that compensation is usually tied to a deliverable.

Although the 2009 modification may have provided the department with more flexibility to prioritize and select only those initiatives that would best fit the department's needs and capabilities, the overall cost of the contract—\$25 million—did not change. As shown in Appendix A, the department paid \$25 million for far less than it had originally bargained. In addition, without contractual language tying the vendor to complete its work, the 2009 modification placed the department in a tenuous position should another dispute arise and the vendor once again threatens to walk away from the contract. The absence of contractual language defining the vendor's obligations further weakens the department's position. Finally, if the 2009 modification allowed the department to pare down

the initiatives to align with what it could have supported, we question the department's judgment in 2008 when it embarked on what appears to have been an overambitious \$25 million project.

Second, the 2009 modification removed a contractual constraint limiting payment to CGI to \$9.8 million for work associated with the 2008 contract, Phase 1. The 2009 modification effectively allowed CGI to receive the remaining compensation of \$15.2 million from new collections without first completing deliverables from the 2008 contract, Phase 1. According to the 2008 contract, CGI would perform the Phase 1 Collections Initiatives, which consisted of eight initiatives, and the department would pay CGI one-third of the department's collections arising from that work until such time as CGI has been paid \$9.8 million in fees. Upon reaching the compensation threshold of \$9.8 million, the department had "no further obligation to compensate CGI for the Phase 1 Collections Initiatives." CGI would then be obligated to begin each of the 2008 contract Phase 2 initiatives on a one-by-one basis as the cumulative compensation thresholds to CGI were achieved. Phase 2 consisted of 14 initiatives.

Third, the 2009 modification deleted contract provisions relating to the acceptance of software deliverables and warranties. This deletion removed the department's ability to require the testing, approval, and remediation of faulty deliverables, in addition to the ability to hold the vendor accountable for defects and system integration problems during the warranty period. In other words, if problems arose with work completed by CGI, the department could not hold CGI accountable to fix the problems. The 2008 contract included several sections that defined the acceptance procedures for both written and software deliverables and included test procedures and remediation requirements if defects were found. The 2009 modification, however, deletes these sections by stating that they "shall not apply."

Warranties are typically included in state contracts. Without such warranties the department has no contractual ability to hold the vendor accountable for potential defects and system integration problems. Thus, when CGI completes its work and leaves on June 30, 2011, the department has no recourse should problems arise.

The department's advising deputy attorney general did not have concerns with the 2009 modification being written without deliverable dates, testing requirements, or warranty stipulations. He stated that the contract speaks for itself and that as the lawyer for the department he knows that there has never been a warranty issue that needed to be addressed. The governor's chief of staff acknowledged that this was

not a traditional contract. The deputy attorney general said that the vendor does not get paid unless it generates new collections. Once the collections are realized, the contract is satisfied.

Both of these answers are shortsighted. Whether warranty issues have been raised in the past is irrelevant to future potential problems that could occur as modifications are made to the computer system. In addition, even though the intent of the 2009 modification was to bring in revenue, the vendor was required to make changes to the computer system in order to fulfill the contract. The fulfillment of the revenue generation requirement of the contract should not absolve the vendor from responsibility for changes it made to the department's computer system.

Finally, the 2009 modification does not hold CGI accountable to complete the initiatives set forth by the department. The modification provides that CGI's obligations to provide all services under the 2009 modification shall be deemed complete by June 30, 2011, thereby relieving CGI of any obligation to complete on-going initiatives. The director believes that CGI will complete the work because "their reputation is more than finishing the job." The director also said that CGI is a large company and if it were to stop work, Hawai'i would have "a negative outlook" on it.

CGI's project manager stated that the State has already paid CGI the maximum \$25 million for the current contract. Further, he stated that the State could ensure that the work will be completed because the contract was based on a sound partnership. CGI was paid to maximize tax revenue, and all decisions have been made on that basis.

The DoTAX's funding mechanism for its ITIM system will end

The DoTAX has relied on performance- and benefits-based contracts to fund its IT system enhancements. The department paid for both its 1999 ITIM system contract and 2008 Delinquent Tax Collections contract from the tax revenues collected by these automated tax systems. The 1999 contract's funding and procurement was very transparent—the Legislature appropriated funds for the development of the IT system and the competitive sealed proposal procurement method was used. In comparison, the 2008 contract was less transparent—the contract was funded by a trust account that does not go through the legislative appropriations process and the sole source procurement method was used. Finally, the department will have to grapple with how to fund its ITIM system's ongoing demands after June 30, 2011, when the funding from additional tax revenue will cease.

The 1999 ITIM system contract's performance-based funding was transparent

The initial acquisition of the ITIM system was very transparent. The Legislature appropriated funds for the redesign and acquisition of the system, and the development work was procured using the competitive sealed proposal-request for proposal (RFP) procurement method. A special fund was established to meet the obligations of the contract, and the department was required to provide progress reports on the project to the Legislature.

Act 273 (SLH 1996) authorized the department to enter into performance-based contracts for the redesign and acquisition of the new ITIM system. The director was required to report to the Legislature the status of the contract and provide an accounting of all moneys appropriated and detailed information on the cost and benefits of implementing the automated tax systems, the amount of increased tax, interest, and penalties collected, and the amount paid to the vendor.

Act 155 (SLH 1999) established the Integrated Tax Information Management Systems Special Fund in the state treasury that consists of general excise tax revenues. The fund moneys were intended to be used by the department to pay for the system contracts. The department was also required to submit an annual report to the Legislature providing an accounting of the receipts and expenditures from the fund, which it did for 2002, and 2005 through 2007. The special fund was repealed on July 1, 2005.

The contract was procured using the competitive sealed proposals-RFP procurement method, and the contract term was not to exceed ten years. The comptroller, in consultation with the director of finance, reviewed and approved the financing arrangement. As required by the RFP process, public notices were posted soliciting proposals for a business partner to provide an integrated tax information management system; proposals were evaluated by the department; and an award was made to CGI's predecessor, AMS.

The 2008 contract benefits-based funding was less transparent

Unlike the 1999 ITIM system contract, the 2008 Delinquent Tax Collections contract was funded by a trust account that does not go through the legislative appropriations process. The department attempted twice to establish an Integrated Tax Services and Management Special Fund for the 2008 contract. The department then resorted to creating a trust account from what has been characterized by some department personnel as a "loophole" in the statutes. The trust account would reflect the moneys collected from the delinquent tax collection project identified accounts as well as the payments made to CGI for the contract,

all without legislative appropriations and approvals and without utilizing the department's budget. We confirmed that both the 2010 Senate Ways and Means and House Finance Committee chairs were not aware of this payment arrangement. In addition, the department used the sole source procurement method, which does not involve competition. According to the department, the 2008 contract was procured using this method because of the proprietary nature of the ITIM system. Overall, both the 2008 contract's payment process and procurement method were less transparent than the prior contract.

In July 2007, the department sought legal advice from the Department of the Attorney General regarding authority to contract without legislative appropriation. The department advanced Section 231-13, HRS, as a possible legal authority for the intended contract. Section 231-13, HRS, provides that the director of taxation shall be responsible for collection of all delinquent taxes and may select and retain bonded collection agencies, licensed attorneys, accountants, and auditors or *other persons* for the purpose of assessment, enforcement, or collection of taxes. According to the law, all compensation can be paid out of the taxes recovered for the State or from the debtor according to the amount authorized by the contract.

The Department of the Attorney General responded that a strong argument can be made that Section 231-13, HRS, permits the contract because the vendor would qualify under the broad *other person* language of the statute. The response concluded that "a court would construe section 231-13, Hawai'i Revised Statutes to allow the department to contract CGI for the *assessment, collection or enforcement of taxes*." (emphasis added).

In December 2007, the department requested the governor's approval to enter into a contract with a vendor to assist the department in collecting additional delinquent taxes, stating that there is no cost to the State or the department, and the vendor will be paid a percentage of the new delinquent taxes collected. In truth, however, payments to CGI would be made from the State's general fund revenues. The governor approved the department's request in January 2008.

The Department of Budget and Finance's advising deputy attorney general advised the taxation department that it could establish a trust account as a means to pay CGI since there were no legislative appropriations. The Department of Accounting and General Services (DAGS) defines a *trust account* as a separate holding or clearing account for state agencies and is often used as an accounting device to credit or charge agencies or projects for payroll or other costs. In January 2008, the department requested that DAGS establish a Trust and Agency

Fund account to deposit new delinquent tax collections. In February 2008, DAGS notified the department that the trust account had been established. Moneys collected under the contract would be deposited to the trust account as described in Appendix B.

The contract was procured using the sole source procurement method, which does not involve competition. As required by this method, the department submitted a written request to the State Procurement Office chief procurement officer for review and approval, stating that “the enhancements will have to be coordinated and integrated with the current applications that were developed by CGI to its proprietary software. For that reason, another vendor cannot perform this work in the proprietary software.” The chief procurement officer posted the notice of sole source award on the State’s website and in July 2007, SPO approved the department’s sole source request.

Vendor’s role as a collection agency is unclear

The Department of the Attorney General advised the department that CGI would qualify as an eligible contractor under the broad *other persons* language of Section 231-13, HRS, and the Department of Budget and Finance advised the department to establish a trust account to handle revenues and payments. Even so, it is unclear whether the vendor’s activities fit those of a collection agency and if the 2008 contract’s initiatives are used to assess, enforce, and collect taxes.

Section 231-13, HRS, provides that “the director, by contract, may select and retain bonded collection agencies, licensed attorneys, accountants, and auditors or other persons *for the purpose of assessment, enforcement, or collection of taxes...*” [emphasis added]. In addition, “all compensation shall be *payable out of the taxes recovered* for the State or from the debtor in accordance with the terms of, and up to the amount authorized by the contract.” [emphasis added] The former director questioned whether the 2008 contract fits under this provision of law because CGI is not actually conducting collection agency activities.

The 2008 Delinquent Tax Collection contract included the General Excise Tax Non-filer program. For this program and utilizing the ITIM system, CGI identified general excise tax license holders who had failed to file tax returns and printed and mailed form letters informing them of their non-filer status. The letter provided both general excise tax filing and cancellation procedures. Almost 70,000 letters were sent, generating thousands of inquiries from taxpayers who called, emailed, mailed, and visited the department in response to the letters. Inquiries were handled by the department’s Tax Services and Processing Division, Taxpayer Services Branch, while the division’s Document Processing Branch

expedited the processing of more than 19,000 previously unfiled returns and almost 13,000 license cancellations submitted by the letter recipients. As of June 2010, over 300,000 letters have been sent.

The former director explained that the vendor's activities, which were limited to identifying the non-filers, printing the letters, and paying for postage, differ from those of a collection agency that actually collects moneys. Beyond the vendor's activities, the department did everything else, including fielding inquiries and processing returns and license cancellations.

We reviewed the 2008 contract and noted that the majority of its 22 initiatives—as shown in Exhibit 2.2—do not involve the *assessment, enforcement, or collection of taxes* as required by Section 231-13, HRS. For example, Initiative No. 2, *Integration of Miscellaneous Tax Types and Automated Compliance Check*, involves the integration and automation of seven manual tax types (fuel, franchise, estate and transfer, liquor, tobacco, public service company, and timeshare occupancy tax) into the ITIM system. Similarly, Initiative No. 11, *Customer Relationship Management Implementation*, involves the implementation of a software tool and a strategy for interacting with customers. The new tool allows the department to better manage its workload by consolidating all interactions with the taxpayer. And Initiative No. 13, *ITIMS Server/Disk/Workstation Capacity*, which involves increasing server, workstation, and disk storage capacity, accommodates processing volume growth rates over a five-year period. Thus, even if needed, these initiatives do not appear related to *assessment, enforcement, or collection of taxes* as required by law.

Exhibit 2.2

2008 Contract Initiatives

#	Initiatives	Phase	Cost
1	Registered Business Non-Filer Enhancements	1	\$580,000
2	Integration of Miscellaneous Tax Types and Automated Compliance Check	1	\$2,110,000
3	Automated Address Updates	2	\$304,000
4	Self Service Payment Agreements Through IVR	1	\$268,000
5	Support Fed-State Compare for Office Audit	1	\$1,550,000
6	Audit Case Management Enhancements	2	\$1,520,000
7	Additional Reports to Support Audit	2	\$250,000
8	Risk Modeling	2	\$1,473,000
9	Enhanced Audit Data Warehouse	1	\$1,328,000
10	Electronic Data Sources Audit Data Warehouse	2	\$320,000
11	Customer Relationship Management Implementation	2	\$3,298,000
12	Virtual Call Center & Automated Phone Calls for Collections	2	\$895,000
13	ITIMS Server/Disk/Workstation Capacity	2	\$1,300,000
14	System Software Upgrades	2	\$911,000
15	Personal Inc Tax Fraudulent Refund Detection	2	\$580,000
16	Audit Review of Corp Inc Tax Refund and Amended Returns	1	\$320,000
17	Collections Business Process Improvements	2	\$250,000
18	Tax Processing Business Proc Improvements	2	\$810,000
19	Additional Delinquent Tax Support (Part 1)	1	\$2,125,000
20	Additional Delinquent Tax Support (Part 2)	2	\$2,125,000
21	Design Changes (Part 1)	1	\$1,070,000
22	Design Changes (Part 2)	2	\$1,070,000
	Contingency for Interest		\$500,000
	TOTAL COST:		\$24,957,000

Source: Department of Taxation

Moreover, the bulk of the revenues generated by CGI came from the first initiative—the registered business non-filer enhancements—which cost an estimated \$580,000 out of the \$25 million paid, or about 2 percent of the total contract cost. The moneys generated by the non-filer program were used to pay for other initiatives. If the goal was to generate revenue, the department would have accomplished this by contracting only for the non-filer program, with a savings to the State of about \$24.4 million. The additional revenue generated from this program would have been deposited to the State's general fund.

The Department's Infrastructure Cannot Sustain the Current Rate of System Enhancements

The 1999 ITIM system project was to have ended in 2004, but is still on-going and straining the department's limited IT staffing resources with continuous projects, tax law changes, enhancements, and fixes. As a result, the department has become dependent on its IT vendor to supplement on-going IT work as well as resolve long-standing system problems.

The department has failed to establish and implement an IT strategic plan to address its processes, organization, technology, and people. The department now faces the impending June 30, 2011 departure of its IT vendor without an IT strategic plan that lays out how it will support the maintenance and enhancement of its ITIM system with its existing staffing and budget.

DoTAX IT staff cannot keep up with the department's ongoing system demands

Since the advent of the 1999 ITIM system project, the DoTAX has moved from one project to the next, implementing new initiatives to modify and upgrade the system. In addition to these initiatives, the department's IT and System Administration Office staff have had to contend with ongoing tax law changes, as well as system enhancements and fixes. During this period of initiatives and enhancements, the department failed to acknowledge that it was taxing its personnel beyond their capabilities. We found that the internal IT staff are frustrated by too much work and not enough time. System administrators are spending the majority of their time doing system testing at the expense of other responsibilities. As a result, long-standing system problems have remained unresolved for years. In addition, staff shortages required the vendor to assist with these otherwise unmet needs.

DoTAX has been in near continuous project development mode for more than a decade

In 1999, the DoTAX commenced a five-year, \$51 million ITIM system project to replace its aging computer systems. By October 2004, the project completed six major system implementations including the replacement of the Comprehensive Net Income Tax (CNIT) computer system in 2002 and the General Excise Withholding/Transient Accommodations (GEW/TA) system in 2004.

Between January 2005 and January 2008, 13 additional projects and enhancements were added to the system. At the same time, the department also contracted in September 2006 with the same IT vendor to implement the County Surcharge Taxes project. The purpose of this \$2.44 million project was to enhance the ITIM system to allow the system to process and distribute county surcharge taxes. This additional

tax of 0.5 percent on the State's general excise tax is imposed by the City and County of Honolulu, but levied, collected, distributed, and otherwise administered by the State.

Then, in January 2008, the department put into effect the \$25 million ITIM system post implementation Delinquent Tax Collections Initiatives, which called for 22 collection initiatives to be completed by June 2011. This contract was later superseded by a modification in June 2009, which reduced the number of initiatives to 21.

In addition, tax law changes (TLCs) were continuously being implemented. Using the DoTAX annual reports, we calculated an average of 18 TLCs per year since 2005, including the 2006 county surcharge. However, not all TLCs result in ITIM system changes. For example, for the period January 2009 through January 2011, six of a total of 14 TLCs impacted either IT staff development or TLC team testing.

Throughout this period, bug fixes and system enhancements were being developed, tested, and put into builds to resolve issues and implement new system enhancements. A *bug* is a problem with how the system is working while an *enhancement* is a change to the system that adds capabilities or makes the system more efficient. *Incidents* are occurrences of problems, and when grouped together, are called *builds*. To address system problems, a department build coordinator works with the system administrators and IT staff to prioritize all incidents that are identified each week. Due to a shortage of personnel, department staff said that only critical incidents can be addressed. Non-critical issues are set aside and worked on only as time permits.

Based on this prioritization process, the build coordinator creates a *build list* consisting of several incidents that are grouped together into a build. We found that between August 2005 and June 2010, a total of 103 builds have been completed, which amounts to approximately 1.8 builds per month or one new build being implemented every 17 days. Since each build includes multiple incidents, we obtained from the department a breakdown of the number of incidents in each build from 2005 through 2010. We selected and reviewed the builds for 2009 and found that for that year's 16 builds, there were 174 production and TLC incidents, or just over 10.8 incidents per build.

Each incident included within a build goes through an extensive *change management process*, which includes the following steps:

- Department system administrators discuss and prioritize the incident;
- One committee reviews and approves the development;

- The build coordinator organizes the incidents into builds, which must be approved by another committee;
- Developers develop a solution and test; and
- System administrators test again before the build is finally put into production.

This process is repeated from the development stage if any flaws in the solution are discovered during testing. Each hour of development time requires two hours of testing. Department staff believe there are too many incidents and not enough system administrators to complete testing. Currently, system administrators are spending about 75 percent of their time testing, which is significantly higher than the 40 percent allocated in their position descriptions.

A former IT project manager stated that the department was always in project development mode, which kept the internal IT staff too busy and did not allow time for the system to stabilize. Still others raised concerns about the stability of the ITIM system, the ten years of new projects, and the insufficient internal staff to handle the work. Staff predicted that there will come a “day of reckoning” when the current contracts end and the department must pay for the additional costs of the ITIM system with existing budgets and support the infrastructure with its limited staff.

Staff assessment cites personnel shortfalls

In December 2003, a third-party technology and business solutions provider was requested by the department to provide an independent assessment of staffing needs for the ITS Office. The study's goal was to provide ITS Office staffing requirements for a two-year period ending 2005 and a five-year period ending 2008. The report found that “current [ITS Office] staffing is not adequate to meet all of the office's responsibilities.” According to the study, ITS Office staffing levels fell short of the vendor's estimates, resulting in staff being spread thin. The study cited an early version of the vendor's revised staffing estimate that identified the need for 25 ITS Office positions. At that time, the ITS Office had only 21 technical positions, a number which, according to the study, was not based on actual resource needs, but was a result of budgetary constraints and prior executive mandate. In light of this staffing shortage, the study noted that the department's operating practice was to “make do” with available resources, which resulted in staff feeling strained and underappreciated. In order to address the latest need, the department shifted priorities and deferred important tasks. The study concluded that when the ITIM system project was scheduled to be completed in 2004, there would be a corresponding increase in the demand for application maintenance service.

Today, seven years after the study, numerous enhancements and modifications have been added to the ITIM system, yet the internal IT staffing level has remained almost unchanged. Exhibit 2.3 shows the number of ITS Office staff over the past 12 years from 1999 to present.

Exhibit 2.3 ITS Office Staffing Levels

Number of ITS Office Staff from 1999 – 2010											
1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
13	15	16	16	19	24	25	23	21	21	21	20

Source: Office of the Auditor based on data provided by the Department of Taxation and the department's ITS Office

As shown in the exhibit, the number of internal IT staff increased by five between 2003 and 2004, almost to the level recommended by the vendor's staffing estimate. Since then, ITS Office staffing has steadily decreased from 25 in 2005 to 20 in 2010.

Long-standing system issues have been unresolved for years

In our analysis, we found that long-standing problems with the ITIM system have taken years to address or, in some cases, remain unresolved. We found that these long-standing problems are a result of taking on too much work with too few resources. Since the completion of the original ITIM system project, the department has initiated new enhancements and projects without the required staffing resources to address the increasing development and testing requirements. In late 2007, the ITS Office identified 18 outstanding problems with the ITIM system. During our audit work, we noted additional long-standing problems and analyzed two such problems: unexpected failures of portions of the ITIM system and mismatches in data between the department's two accounting systems.

The ITS Office chief stated that the office experienced as many as 70 failures a day. These failures, which had been plaguing the office since 2002, were associated with the system's *virtual application servers*, which process requests from ITIM system users to update the system's database. The ITIM system has 28 such servers shared amongst about 300 tax department users. When a virtual application server fails, the user is re-routed from the failed server to another one. As a result of the failures, a user may experience slow response time or may be required to log in again. The department asserts that the problem was not significant enough to affect daily operations. However, the department

acknowledged that during 2006 and 2007, the servers were failing faster than they could be restarted. In November 2008, a representative from Gartner, an IT research and advisory company, opined that for a system to fail that frequently is “way out of line.”

The department’s senior management claims that it only became aware of the issue in Fall 2008, and that once reported, the problem was given a high priority and resolved by the vendor. For department management to be unaware of these six-year-old issues raises legitimate concerns about the department’s oversight of its IT contracts and vendor and reveals, at the very least, a problem with its identification and prioritization process.

In spite of its claim that it was not aware of the failing application servers, department management stated that “priority for development and system testing resources is assigned based on the operational impact of the problem/issue.” The department said that while the application server problem created a challenging situation for the internal IT staff, it was not raised as a priority and, therefore, development and system testing resources were assigned elsewhere. This explanation reveals a prioritization process driven by too much work and insufficient staffing resources.

Another long-standing problem is related to a mismatch in the transaction data between the department’s tax accounting (TA) system and its revenue accounting (RA) system. This problem was entered into the department’s incident tracking log in May 2003. It was not until 2009, however, that the matter was made a priority. That year, 13 data mismatch entries were added to the tracking log. Of the 13 incidents, several had balance differences of several hundreds of thousands of dollars, with the highest difference being in excess of \$4.3 million. As of July 2010, there were 241,753 existing transaction mismatches.

The department lacks the resources to address the problem in a timely manner. This issue was discussed in the Issues Committee, which met weekly to discuss concerns related to the department’s IT contracts. In the minutes of a June 2009 meeting, a department manager emphasized the importance of addressing the discrepancies by stating that they should be reconciled monthly by dedicated individuals with the requisite expertise and knowledge. However, the manager also stated, “With the various initiatives we are currently tasked with, where does it fall in the priority list? At the current time, we do not have the bandwidth, resources, etc., to undertake this initiative.” Over time, the department’s prioritization of new project related initiatives over the resolution of existing issues with its systems has resulted in backlogs of problem fixes. Of greater concern is the apparent lack of management oversight of the department’s IT contracts and vendor.

Department staff shortages were filled by vendor

The tax department management has allowed the vendor to become a fixed component of its IT system administration and infrastructure. The department has become dependent upon the vendor's expertise and additional personnel to supplement its system administration and technical support needs. Without a sufficient transition plan to fill the void left by the departure of its long-term vendor in June 2011, the department will struggle to support its IT systems and fulfill the tax collection needs of the State.

Several supplemental agreements and contracts put into effect after the original five-year 1999 ITIM system project provided vendor production support hours for the department. *Production support hours* are hours for the vendor to provide services on the ITIM system for incidents and enhancements as determined by the department. They can be used for a variety of services, including system development, testing, and analysis. The total number of production support hours made available to the department from these supplemental agreements and contracts totaled 48,200 hours. This is equivalent to over 23 years of work for one employee. At one time, approximately 15-20 vendor staff were working within the department. Currently, the vendor has ten full-time employees onsite at the department, and the department has yet to determine how it will absorb work that has been provided by the vendor.

Department managers confirmed the lack of sufficient internal staff to complete system testing and reliance on the vendor for assistance. In spite of concerns by department system administrators, the vendor would also perform user acceptance testing, meaning that the vendor would test its own product. In these instances, according to a department manager, department staff would always review that the job was complete and satisfactory. Even so, this conflicts with best practices that require IT product testing be conducted by a party other than the product developer.

In addition, the ITS Office has the right of first refusal for IT development work. If internal IT staff could not complete the job, the ITS Office could pass it on to the vendor. According to the department's incident tracking log, the vendor has been assigned 594 incidents compared to 6,047 for internal IT staff. Based on these assignments, the vendor assumes about 10 percent of the bug fix and system enhancement development workload.

In addition to staffing, the department also relies upon the vendor for its technical expertise. In May 2010, the vendor identified work that it conducts for the department on a recurring basis: production support in the form of incident and enhancement development work, testing support to assist the department system administrators, and research and analysis

support for issues such as tax law changes. The vendor also provided consulting services to the department for both technical and functional management decision-support analysis. Given this reliance on the vendor, we question the ability of the ITS Office to maintain the system after the vendor leaves with its current staffing levels.

The DoTAX's IT strategic plan is outdated, narrowly focused, and shortsighted

The department's narrow and shortsighted focus on generating revenue has hindered its ability to strategically manage the long-term effects of IT initiatives. The department does not have a functional IT strategic plan and its Act 100 (SLH 1999) report provides no meaningful long-term strategies and little guidance to fulfill the goals of its IT systems. In fact, the department has no effective department-wide strategic plan.

Since implementing the ITIM system in 1999, the department has spent about \$87 million through its major contracts with CGI. Yet, without an IT strategic plan that maps out the long-term goals and processes to assess the accomplishments of its major systems, the department is unable to demonstrate that the moneys have been spent purposefully and effectively. The importance of and need for long-term planning by the department is heightened by the fact that it is the primary revenue-generating mechanism for the State.

The department does not have an IT strategic plan

The department does not have a strategic plan for its IT systems. We confirmed with the former director of taxation and other department managers that there may have been an IT systems strategic plan during the time of the 1999 ITIM system project, but the department currently has no formal IT plans. Department management has referred to the 1999 ITIM system contract, service agreement Statement of Work No. 2, also known as the blueprint report, as the document most similar to an IT strategic plan.

The blueprint report, which was a contract deliverable, documented the high-level model of the integration of the vendor's 1999 ITIM system project. While this report adequately addressed four key elements of an effective IT strategic plan—process, organization, technology, and people—we found that the plan was specific to the 1999 ITIM system project and has not been updated to address changes in processes, policies, organizational structures, and other infrastructure components. Also, because it was a deliverable of the contract and not considered prior to the contract's formation, the report does not take into account cost-related factors.

According to CobiT, a generally accepted internal control framework for IT, an IT strategic plan should:

- Define, in co-operation with relevant stakeholders, how IT goals will contribute to the enterprise's strategic objectives and related costs and risks;
- Include how IT will support IT-enabled program investments, IT services, and IT assets;
- Define how the objectives will be met, the measurements to be used and the procedures to obtain formal sign-off from the stakeholders;
- Cover investment/operational budget, funding sources, sourcing strategy, acquisition strategy, and legal and regulatory requirements; and
- Be sufficiently detailed to allow for the definition of tactical IT plans.

The DoTAX management failed to update and implement a meaningful IT strategic plan after the initial ITIM system project ended. Relying on CobiT or other IT best practices, the department should develop an overall IT strategic plan to ensure that the planning for IT systems has sound goals and objectives and is supporting the overall departmental goals.

DoTAX has taken an ad hoc approach to IT systems development

We found that for its 2008 contract and 2009 modification, the department did not determine the impact of the proposed initiatives, how IT systems and projects support and align with overall department business goals, nor assess IT readiness elements. We asked several DoTAX managers for documentation on the department-wide and IT strategic planning performed for the 2008 contract and 2009 modification. What we received was documentation that minimally relates to planning and focuses more on estimated revenue generation from the initiatives. Moreover, department managers, including the former director, were not involved with the contract modification.

DoTAX has attempted to implement a strategic plan at annual retreats, but with no success. The August 2005 and August 2006 agendas included items that focused on strategic planning, including future visions, revenue enhancing strategies, and short- and long-term goals and

objectives, but nothing was formalized thereafter. Similarly, the August 2008 retreat focused on strategic planning basics, including strategic planning objectives, mission and vision statements, goals, objectives, action plan, and performance measures. According to some of the managers, though, only the mission statement was completed.

In early 2009, senior management discussed whether the department needed a new IT system since the ITIM system project was almost at the end of its life cycle. The former deputy director worked with a consultant to gather information and other states' input. The department discussed the ITIM replacement system in a presentation for staff. Both the tax services and processing administrator and the administrative services officer prepared drafts of the ITIM replacement system for users. However, this project stopped after the former deputy director left. Thereafter, the successor deputy director, who is now the current director, did not pursue it; hence, no planning was done.

The *Board Briefing on IT Governance*, which was developed by the IT Governance Institute, a not-for-profit organization with a mission to assist enterprise leaders in their responsibility to make IT successful in supporting the enterprise's mission and goals, defines IT governance as the responsibility of the board of directors and executive management. It is an integral part of enterprise governance and consists of the leadership and organizational structures and processes that ensure that the organization's IT sustains and extends the organization's strategies and objectives. Critical to the success of these structures and processes is effective communication among all parties based on constructive relationships, a common language and a shared commitment to addressing the issues.

The department's inability to successfully implement a strategic plan and perform strategic planning for the 2008 contract and 2009 modification is the result of a lack of leadership. The downturn in the economy and decrease in tax collections shifted the State's and the department's focus to increasing tax revenue collections.

Transition plan has elements of strategic planning, but lacks management input and may be too little, too late

Senate Concurrent Resolution No. 78, SD 1, of the 2010 legislative session requested that DoTAX establish and implement a transition plan where DoTAX will assume all functions performed by CGI for the 2009 modification. During a June 2010 Ways and Means (WAM) Committee informational briefing, DoTAX submitted a draft transition plan prepared by the ITS Office. As of November 2010 (and now long overdue), the department is still working to develop this transition plan, calling into question management's effectiveness to plan strategically.

The draft transition plan appears to have been the result of SCR 78, SD 1, and driven by a need to transition to the next administration rather than a self-initiated DoTAX process performed periodically to address long-term needs. In testimony provided during the WAM informational briefing, the director stated that it has been his experience that transition plans are normally prepared when there is a transition from one administration to the next. The ITS Office chief stated that while he has been tasked to write the transition plan for SCR 78, SD 1, he has not collaborated with other DoTAX management and has left sections for the Compliance and Tax Services and Processing Divisions to complete.

According to CobiT, the IT strategic plan should define, in cooperation with relevant stakeholders, how IT goals will contribute to the enterprise's strategic objectives and related costs and risks, and should include how IT will support IT-enabled program investments, IT services, and IT assets. It should also cover investment/operational budget, funding sources, sourcing strategy, acquisition strategy, and legal and regulatory requirements. The draft transition plan we reviewed included the following key areas: 1) future contracts; 2) transition of current implementations by current vendor; 3) legislative and departmental initiative funding planning; and 4) budget transition planning. We note, however, that as of November 2010, the plan was not yet complete. Lacking a completed transition plan and the involvement of all responsible managers, the budget to hire more internal IT staff, and the skill and knowledge to program proprietary code, it is unlikely that the department will be able to continue maintenance and enhancement of its IT system without difficulty.

According to the former deputy director, consideration for the transition away from dependency on CGI was built into the 2009 modification via knowledge transfer initiatives; however, this may have been too little, too late. The former deputy director stated that transition was not heavily emphasized in the 2008 contract where the focus was on revenue generation, but was included in the 2009 modification. Although there had been talk about knowledge transfer from CGI to the ITS Office throughout her term, internal IT staff turnovers, especially departures of key people, has made transition difficult.

Conclusion

The Department of Taxation is the State's primary revenue generating entity. Therefore, the success of its tax collection functions is of critical importance to the well-being of Hawai'i's residents. However, a lack of planning and insufficient resources to support a growing IT infrastructure threaten to cripple these important systems. To meet these and other challenges, the department must first wean itself from a vendor which it has grown dependent on for essential services. Secondly, as it

prepares for a new administration and new leadership, it must overcome the internal strife that resulted from its vendor relationship. Finally, and most importantly, DoTAX must begin an IT strategic planning process that establishes long-term goals and strategies and enables the department to operate effectively, efficiently, and independently.

Recommendations

The Department of Taxation needs effective leadership to take a stronger role in the overall planning and management of its IT systems. It also needs to attend to practices and problems that eroded working relationships among employees and the vendor by managing various intra-agency factions and training staff in project management skills to properly maintain and upgrade increasingly important information systems.

1. The Department of Taxation should:
 - a. Develop and implement an effective IT strategic plan to guide the department's efforts to sustain and extend department-wide strategies and goals and ensure the plan addresses the four key elements of process, organization, technology, and people;
 - b. Discontinue any further enhancements to the IT system unless required by law until the department's needs and priorities are addressed through IT strategic planning;
 - c. Ensure the transition upon the completion of the 2009 modification is completed and results in a sustainable and ongoing support and maintenance of its IT systems; and
 - d. Better manage its future IT systems by establishing an adequate project and contract management methodology and ensuring project management is competent to hold vendors accountable.
2. With regard to the department's management conflicts, the department should:
 - a. Tackle the root cause of problems impeding the department's performance. A cultural transformation will be the key to the department's success. The existing culture of hierarchical management approaches will need to yield to one of partnerships among managers; process-oriented ways of doing business will need to yield to results-oriented ones, and organization "silos" will need to become integrated.

- b. Improve its performance by altering the way department leaders and managers treat each other and manage their people, as well as building commitment and accountability through involvement and trust. Effective changes can only be made and sustained through the cooperation of management and staff throughout the department.
3. During our audit we were hampered in our review of documentation due to taxpayer confidentiality issues. The Legislature should consider amending the department's statutes to coincide with the Internal Revenue Code to allow state audit agencies authorized under the laws of the State to audit state revenues and programs.

Issues for Further Study

During our audit we encountered areas of concern that were out of our scope but we considered significant to warrant further study.

Issues raised in the IRS safeguard review audit

In March 2009, the U.S. Department of Treasury Internal Revenue Service conducted a safeguard review of the DoTAX under Sections 6103(d) and (I)(10), Internal Revenue Code. The review was limited to the safeguards used to protect the confidentiality of federal tax returns and return information as applicable to the DoTAX. We reviewed the safeguard review audit report and noted that a significant portion of the audit findings and recommendations were related to computer security (80 pages of the 95 page report). The audit included an evaluation of the management, operational, and technical controls safeguarding federal tax information. Findings are grouped under headings such as management, operational, and technical controls. Because the audit reported a significant number of findings related to IRS data and how they were being handled, and because it included more than 70 findings concerning procedures and general processes, we deem this significant enough to warrant further study.

ITIM system general and application control issues

During our audit work, we encountered concerns over general and application control issues related to the ITIM system. For example: 1) the ITIM Tax Processing system does not have a cash control account, and thus bank reconciliations cannot be performed and the state revenues collected cannot be verified; 2) controls are not in place to ensure manual adjustments to the system are approved and verified; and 3) there is an inadequate timeframe within which to address and resolve incidents and problems of all severity levels. We could not determine the actual number of incidents that remain unaddressed and unresolved because

the department did not provide us access to the data due to taxpayer confidentiality. Until the law regarding access to confidential taxpayer information is amended, however, this issue cannot be addressed.

Revenue accounting table information

We also encountered concerns over the delete/archive initiative, in which information in the revenue accounting table may be inappropriately deleted. Because this concern was beyond the scope of our audit, we did not delve further into this topic but would recommend it as an issue for further study.

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Appendix A
Comparison of Initiatives for the 2008 Contract and 2009 Modification

#	2008 Contract Initiatives	#	2009 Contract Modification Significant Revenue Generating Initiatives	#	2009 Contract Modification Initiatives Currently in Progress
1	Registered Business non-filer enhancements	1	Registered Business non-filer enhancements	1	Non-filer initiatives
2	Integration of Miscellaneous Tax Types and Automated Compliance Check	2	Self Service Payment Agreements through IVR	2	Automated Phone Payment (IVR) Plan
3	Automated address updates	3	Fed-State Compare for Office Audit	3	Audit Data Warehouse
4	Self Service Payment Agreements through IVR	4	Enhanced Audit Data Warehouse Tool	4	Federal State Compare
5	Support Fed-State Compare for Office Audit	5	Additional Electronic Data Sources – Audit Data Warehouse	5	Integration of Miscellaneous Taxes
6	Audit Case Management Enhancements	6	Automated Address Updates		
7	Additional reports to support audit	7	CP2000 Case Management Automation		
8	Risk Modeling	8	Additional Reports to Support Audit		
9	Enhanced Audit Data Warehouse	9	Risk Modeling		
10	Electronic Data Sources Audit Data Warehouse	10	Personal Inc Tax Fraudulent Refund Detection		
11	Customer Relationship Management Implementation	11	Collections Business Process Improvements		
12	Virtual Call Center & Automated Phone Calls for Collections		Other Revenue Generating Initiatives		
13	ITIMS Server/Disk/Workstation Capacity	1	Integration of Miscellaneous Tax Types and Automated Compliance Check		
14	System Software Upgrades	2	System Software Upgrades		
15	Personal Inc Tax Fraudulent Refund Detection	3	Tax Law Changes		
16	Audit Review of Corp Inc Tax Refund and Amended returns	4	Audit Case Management Enhancements		
17	Collections Business Process Improvements	5	Risk Modeling		
18	Tax Processing Business Proc Improvements	6	Tax Processing Business Process Improvements		
19	Additional Delinquent Tax Support (Part 1)	7	Design Changes		
20	Additional Delinquent Tax Support (Part 2)	8	Additional Maintenance Support		
21	Design Changes (Part 1)	9	Modernized e-File		
22	Design Changes (Part 2)	10	Data Entry Support		
					Other Initiatives Not Part of the 2009 Modification Currently in Progress
				6	Archiving Initiative
				7	Batch Performance Tuning
				8	Migration Upgrades (Hardware and Software)
				9	Technical Documentation and Knowledge Transfer
				10	System Testing Training
				11	ITIMS Imaging System Filenet Upgrade (Hardware and Software)
				12	Penalty and Interest Package
				13	Production Support

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Appendix B

Payment Process to the Vendor

(According to the 2008 Contract Terms)

Step	Description
1.	All tax payments, including moneys collected as a result of the CGI contract (the “Tagged amounts”), are deposited into DoTAX Tax Collections Trust Account. DoTAX shall prepare a Treasury Deposit Receipt for the deposit of such moneys and submit it to the Department of Budget and Finance (B&F) for processing. B&F then forwards a copy of the validated Treasury Deposit Receipt to the Department of Accounting and General Services (DAGS) for recording in the accounting system.
2.	Upon receipt of monthly payment report from CGI, DoTAX transfers the “tagged” amounts to an administratively established trust account.
3.	Payments to CGI are made from the administratively established trust account. CGI issues an invoice to DoTAX for the portion of the Tagged amounts that it is claiming as compensation under its contract. Upon approval of CGI's invoice, DoTAX shall prepare a summary warrant voucher to be submitted to DAGS so that payment can be made from the administratively established trust account to CGI.
4.	By journal voucher submitted to DAGS, DoTAX will then transfer from the administratively established trust account to the DoTAX Tax Collections Trust Account, the net balance of the “tagged” amounts less amounts to CGI.
5.	DoTAX prepares its monthly Statement of Tax Operations and submits it to B&F and DAGS. The monthly Statement of Tax Operations includes the net balance of Tagged amounts, after payments to CGI.
6.	Lastly, B&F and DAGS will prepare the appropriate journal vouchers to distribute the tax receipts as indicated by DoTAX's monthly Statement of Tax Operations from the DoTAX Tax Collections Trust Account to the general fund and other recipients.

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Response of the Affected Agency

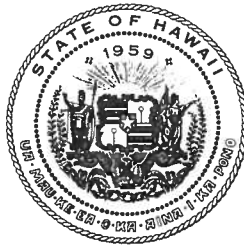
Comments on Agency Response

We transmitted a draft of this report on December 20, 2010 to the Department of Taxation. A copy of the transmittal letter to the department is included as Attachment 1. The department's response, submitted on December 22, 2010, is included in its entirety as Attachment 2.

In its response, the department expressed its appreciation for the Legislative Auditor's report. According to the interim director, the department has initiated corrective actions that will address some of the recommendations noted in our report. The corrective actions include the addition of a position count to the Information Technology System Office to augment short staffing, as well as training an additional ten system administrators to supplement system quality assurance resources. The department is also in the process of identifying project management training opportunities that are available locally. Lastly, the interim director assured us that the department will continue to review our recommendations as it monitors for improvements.

ATTACHMENT 1

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917



MARION M. HIGA
State Auditor

(808) 587-0800
FAX: (808) 587-0830

December 20, 2010

COPY

The Honorable Fred Pablo
Interim Director
Department of Taxation
Princess Ruth Ke'elikōlani Building
830 Punchbowl Street
Honolulu, Hawaii 96813

Dear Mr. Pablo:

Enclosed for your information are three copies, numbered 6 to 8, of our confidential draft report, *Management and Financial Audit of Department of Taxation Contracts*. We ask that you telephone us by Wednesday, December 22, 2010, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Monday, December 27, 2010.

The Governor and presiding officers of the two houses of the Legislature have also been provided copies of this confidential draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa
State Auditor

Enclosures

NEIL ABERCROMBIE
GOVERNOR

BRIAN SCHATZ
LT. GOVERNOR



STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
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FREDERICK D. PABLO
INTERIM DIRECTOR OF TAXATION

RONALD B. RANDALL
ACTING DEPUTY DIRECTOR

December 22, 2010

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OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion Higa, State Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

Dear Ms. Higa:

Thank you for the opportunity to review the draft report entitled "Management and Financial Audit of Department of Taxation Contracts."

As the issuance of the draft report coincided with my first day as the Interim Director for the Department of Taxation, I am not yet familiar with the circumstances described in the report and my comments are limited to briefings from the staff. I can inform you that corrective actions have been initiated and are continuing to address some of the recommendations noted in the draft report to include:

- The addition of a position count to the Information Technology Systems Office (ITSO) to augment short staffing;
- Training of an additional ten System Administrator to supplement current system quality assurance resources;
- Identifying locally available training for project management

The Department appreciates the Legislative Auditor's review of the CGI contracts for the period ending June 2010, including contracts dating back to 1999, values its assessment and continues to review observations and recommendations for improvements.

Sincerely,

FREDERICK D. PABLO
Interim Director of Taxation

cc: The Honorable Neil Abercrombie